

**Statement by J. de Beaufort Wijnholds, Executive Director
for Former Yugoslav Republic of Macedonia
May 10, 2000**

The staff has produced a lucid and candid assessment of the economic situation and policies of the Former Yugoslav Republic of Macedonia (FYRM). Indeed, it would be highly desirable if the degree of frankness, indispensable for this Board to focus on the most pressing issues, were copied in the staff reports for all other countries, including larger ones. The authorities' intention to publish the staff report is testimony to Macedonia's increasing transparency and its continuing dialogue with the international community as to the optimal policies to be followed. I believe this report provides a good basis for proceeding with the discussions on a Fund-supported program, which the authorities hope could be in place by late summer. I would also like to take the opportunity to thank the staff for its perseverance in continuing the dialogue with Macedonia and its relentless efforts to assist the country in trying to cope with the very difficult external circumstances of 1999. In this respect, it is worth noting that staff missions to FYRM took place five times since the beginning of 1999, including during the height of the Kosovo crisis. On top of that, the authorities are grateful for the substantial technical assistance they have received from the Fund, in the form of two missions by our Monetary & Exchange Affairs Department, two missions by our Fiscal Affairs Department (FAD) and two FAD resident advisors.

The staff report presents a mixed picture. It should be taken into account, however, that FYRM has faced daunting economic and political challenges over the last decade in its transition to a market-based economy. In this light, the sustained and successful stabilization efforts by the authorities, both fiscal and monetary, are remarkable. Moreover, in spite of the Kosovo crisis, the government was able to continue fiscal discipline and largely retain in 1999 the gains of fiscal adjustment that had been achieved over the period since 1995. In a similar vein, inflation was kept low, foreign exchange reserves increased and the exchange rate remained stable. Notwithstanding these not insignificant accomplishments, the authorities recognize that many difficult further steps have to be taken to put economic growth on a sustainable footing.

These further steps lie mainly in the field of structural adjustment. Progress in this area was delayed in 1999. The new government coalition that had come into power in December 1998 was immediately confronted with the social, political and economic repercussions of the Kosovo crisis, which developed in early 1999. In this environment, it proved impossible for the government to reach agreement on additional structural measures to be taken, in view of possible social impact and the already extremely high unemployment. Nevertheless, with the Kosovo crisis abating, Macedonia continued to remain the island of peace and stability it had been since its independence in 1991 in an otherwise tumultuous region.

In the second half of 1999 the Macedonian authorities were able to focus again on the economic policy agenda. Since then, a number of important initial steps toward reaching agreement on a Fund-supported program have been taken. This process has been reinforced by a government reshuffle at the end of last year. The authorities intend to demonstrate their commitment to further adjustment by taking concrete steps in the next weeks, which would allow for a staff visit in June to discuss a Fund-supported program.

As the staff points out, **macroeconomic policy** has been generally adequate over the last two years. Fiscal policy has remained tight, with the general government achieving a balanced budget in 1999. Efforts to improve the tax administration were highly successful, with actual collections exceeding those budgeted by 6.5 percent (3.4 percentage points of GDP). The Finance Minister acknowledges that the problem of off-budget accounts held by other ministries should be addressed and public expenditure management should be further improved. At his request, the Fund has provided a resident advisor for the current year to set up a centralized treasury function in order to improve on the Finance ministry's oversight function. In addition, a World Bank Public Expenditure Review mission is presently in the field. For 2000, the central government is also budgeting a balanced budget.

A major step this year has been the actual introduction of a **Value Added Tax** as per April 1, with a technical delay of three months. This was a condition under the expired ESAF and also formed a key precondition for the resumption of negotiations on a new Fund program. The first indications are that the implementation of the VAT law has gone smoothly and that resulting price hikes have been less than expected.

It is clear that there are substantial inefficiencies in the **civil service** and that a **reform of the public sector** is required, including a downsizing of the civil service. As an initial but crucial step, the authorities have prepared a register of all public sector employees with a view to assessing the usefulness of individual positions. It should be noted, however, that major lay-offs of civil servants are difficult to defend in social terms, when the unemployment rate is a staggering 32 percent. As a result, there have been delays in taking adequate measures. Nevertheless, parliament has recently passed a law on early retirement, which should allow for a reduction in the civil service that goes a long way in the direction of the policies advised by Fund staff.

On the **monetary** side, the **policies** pursued have had generally favorable effects, with negligible inflation, a stable exchange rate and increasing foreign exchange reserves. It is also very welcome that the National Bank of Macedonia (NBM) has now moved to a system of monetary control based solely on the use of indirect instruments.

The discussion of **exchange rate issues** in the report is frank but fair. I believe that at some point in the future a floating exchange rate regime might be preferable. The authorities have indicated that they would only consider such a step in consultation with the staff.

The staff makes some quite critical observations on **banking sector supervision**. The shortcomings in this field should be seen in the light of the persistent losses in some of the publicly owned industrial enterprises, which has made it extremely difficult for commercial banks to apply proper credit risk considerations in extending credit exposure. In addition, the legacy of pre-independence central planning has been a weak banking sector. This problem has exacerbated in 1999, due to the Kosovo crisis and the resulting social effects. Since that time, positive steps have been taken, however. The largest commercial bank, Stopanska Banka was finally restructured and sold to a foreign investor. This significant measure will have a beneficial impact for the economy as a whole. Another insolvent bank has been closed, in spite of strong domestic resistance. In the field of banking supervision, it should also be pointed out that Macedonia complies favorably with the Basle Core Principles that relate to the regulatory and legal framework. The problem lies with implementation and enforcement. In order to tackle this, the NBM is strengthening its off-site monitoring abilities and increasing minimum capital requirements.

In the area of **structural reform**, I am happy to report that considerable progress has been made recently. Eight out of twelve loss-making enterprises targeted for action under the recent Fund-supported program have now been closed, liquidated or sold. While a few big problem cases remain, it is expected that the pre-appraisal conditions set by the World Bank for a FESAL loan can be met in the near future. This would allow the authorities to reinforce their commitment for reform of the state- and socially owned enterprise sector with World Bank support. In addition, the authorities are determined to improve the investment climate in order to attract foreign investors, including a streamlining of the regulatory framework. Also, a domestic stock market is being developed and the Privatization Agency has been playing an increasingly professional role in divesting state-owned enterprises by adhering to generally accepted standards of transparency and governance.

In sum, the challenges that FYRM faces are enormous, but the authorities have certainly shown their willingness to tackle the problems. Moreover, the authorities regret that the previous ESAF went off-track, but they are determined to conclude an agreement with the Fund during the summer.

Finally, I am afraid I have to take issue with paragraphs 4, 27 and 60 of the staff report concerning the **freeze of certain foreign currency deposits** which constitute a restrictive measure subject to **Article VIII, section 2(a) of the Articles**. This is an issue that also repeatedly comes up in the context of Article IV discussions of other former Yugoslav republics, and which has been dealt with by the staff in a rigid manner. Foreign exchange arising from household foreign exchange savings deposits was not available to Macedonian banks after the breakup of Yugoslavia, since these funds remained in the former National Bank of Yugoslavia. To prevent a bank run, the Macedonian government took over the claims of the former central bank and transformed them into time deposits back in 1992 (see Box 1 of the Recent Economic Developments paper). According to staff, this gives rise to an exchange restriction because it prevents nonresidents holding such deposits from transferring abroad proceeds of current international transactions – mainly interest accruing on these deposits. After the authorities intended to accept the obligations of Article VII, section 2(a),

staff determined that this was the case in June 1998, upon which the Board approved the restriction until the next Article IV discussion or April 30, 2000. Staff now just notes that the approval has expired, but it does not recommend approving it again.

Meanwhile the authorities have tried to devise a system to solve the problem of the frozen deposits, taking into account the country's ability to repay the large stock of foreign currency deposits (DEM 1.05 billion at the end of 1999) and without unduly affecting the balance of payments. The broad content of the legislation, which is described on page 62 of the Recent Economic Developments report, has been developed since November 1999 after consultation with staff. However, only in March 2000 did staff advise the authorities that they would need to issue two classes of bonds, with the obligations to non-residents being serviced with a much shorter maturity, in order to comply with Article VIII. The authorities on their part contended that it would be extremely difficult to make this distinction; that it would be hard to administer and could be easily circumvented; and that this would constitute unequal treatment between domestic and foreign depositors. It appears to me that these objections are valid. In addition, the authorities find that it is extremely difficult, if not impossible, to determine if, among the outstanding frozen deposits, income is included that was generated from current account transactions. The staff's proposal therefore comes across as a too narrow interpretation of the situation. Also, in the authorities' view, the proposed law does not contain any provision that imposes restrictions on the transfer of interest. For this reason, the authorities have asked staff and management to reconsider their finding that Macedonia maintains an exchange restriction.

If the Board nevertheless decides that there is a restriction, I believe the authorities have now set out a clear timetable for resolving the issue. Staff itself points out that the budgetary and balance of payments constraints do not allow for a quicker resolution. In fact, staff had advised the authorities to even further extend the maturity and the grace period of the proposed bond-swap scheme. I therefore believe the proposed twelve-year period is entirely reasonable. I do not think it is helpful to let a member country remain in violation of the Fund's Articles of Agreement for the next twelve years.